

**Management Advisory Report:  
The Internal Revenue Service's Response to  
the Falling Level of Income Tax Examinations  
and Its Potential Impact on Voluntary  
Compliance**

**June 2002**

**Reference Number: 2002-30-092**

**This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.**



DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

INSPECTOR GENERAL  
for TAX  
ADMINISTRATION

June 12, 2002

MEMORANDUM FOR COMMISSIONER ROSSOTTI

*Gordon C. Milbauer*

FROM: (for) Pamela J. Gardiner  
Deputy Inspector General for Audit

SUBJECT: Final Management Advisory Report – The Internal Revenue Service's Response to the Falling Level of Income Tax Examinations and Its Potential Impact on Voluntary Compliance (Review # 200130039)

This report presents the results of our review to (1) analyze revenue agent and tax auditor examination trends from Fiscal Year (FY) 1997 to 2001, (2) evaluate what factors affected the amount of additional taxes they recommended, and (3) assess the Internal Revenue Service's (IRS) ongoing efforts to improve their examination results.

In summary, in recent years the Congress and other stakeholders have raised concerns about the declining examination coverage rate and potential effect on voluntary compliance. From FY 1997 to 2001, the number of income tax return<sup>1</sup> examinations fell 51 percent, from 1.6 million to 779,000 returns examined, while the number of income tax returns filed grew 8 percent, from 128 million to 138 million returns. Thus, income tax examination coverage fell 56 percent for the same period, from 1.27 percent of all income tax returns filed to 0.56 percent, while the associated recommended examination assessments declined 29 percent, from \$24.9 billion to \$17.7 billion.

The decline in the IRS examination rate has important causes and effects. First, the decline is being driven by two major factors: (1) a reduction in the number of Income Tax Revenue Agents and Tax Compliance Officers between FY 1997 and FY 2001, and

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<sup>1</sup> This figure includes U.S. Individual Income Tax Return (Form 1040), U.S. Income Tax Return for Estates and Trusts (Form 1041), U.S. Partnership Return of Income (Form 1065), U.S. Corporation Income Tax Return (Form 1120), and U.S. Income Tax Return for an S Corporation (Form 1120S).

(2) an increase in the time applied to examine each return over the same period. Secondly, as a result, the decline in the number of income tax return examinations is directly contributing to the associated drop in the recommended examination assessments made in two important examination programs, the Non-Coordinated Industry Case Program and the Office Examination Program. Academic studies have shown that examinations are a potent tool to foster voluntary tax reporting compliance and that the indirect impact of the examinations – the amount of tax voluntarily reported on tax returns nationwide – is significantly larger than the direct revenue that results from the examinations themselves. In its January 2002 report, the IRS Oversight Board stated that its most recent survey found that between 1999 and 2001 there was an 11-point drop in the number of Americans that consider it unacceptable to cheat on their income taxes. These falling numbers suggest that voluntary compliance may be eroding, which could be the ultimate impact, and the one of greatest concern.

To address the decline in the examination coverage rate and the potential effect on voluntary compliance, the IRS has taken both short-term and long-term actions to reverse the decline in income tax return examinations. These actions include: (1) reducing details of Income Tax Revenue Agents and Tax Compliance Officers to provide taxpayer assistance during the tax return filing season,<sup>2</sup> (2) hiring more Income Tax Revenue Agents and Tax Compliance Officers, (3) improving income tax examination efficiency, (4) evaluating work processes to improve the delivery of the examination program, and (5) implementing strategies to improve voluntary compliance that permit a reduced reliance on income tax examinations.

Currently, none of the business results indicators directly measures the effect examinations are having on voluntary tax reporting compliance, which is the primary purpose for an examination. To foster voluntary tax reporting compliance we recommend:

- The Commissioners of the Large and Mid-Size Business (LMSB) Division and the Small Business/Self-Employed (SB/SE) Division accelerate implementing an examination strategy based on issue management.
- The Commissioners of the LMSB and SB/SE Divisions continue to obtain stakeholder input concerning the use of a more issue-based examination approach to develop less intrusive and time-consuming techniques.
- The Director, Organizational Performance Division develop a business results component for the LMSB and SB/SE Divisions' respective "Balanced Measures" that indicates the impact examinations are having on voluntary tax reporting compliance.
- The Director, Research, Analysis, and Statistics of Income test the feasibility of conducting an in-depth study across all income tax return classes to determine

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<sup>2</sup> The filing season is the period between January and mid-April when most individual income tax returns are filed.

the amount of income tax voluntarily reported as a result of income tax examinations.

Management's Response: Management's response was due on June 3, 2002. As of June 10, 2002, management had not responded to the draft report.

Copies of this report are also being sent to the IRS officials who are affected by the recommendations. Please contact me at (202) 622-6510 if you have questions or Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

**Management Advisory Report: The Internal Revenue Service's Response  
to the Falling Level of Income Tax Examinations and Its Potential Impact  
on Voluntary Compliance**

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**Table of Contents**

Background .....	Page 1
Internal Revenue Service Actions Underway to Address Concerns Over Declining Examination Rates and Results .....	Page 4
Declining Field and Office Examination Coverage Likely Contributing to Reducing Voluntary Income Tax Reporting Compliance .....	Page 8
<u>Recommendation 1:</u> .....	Page 17
<u>Recommendations 2 through 4:</u> .....	Page 18
Appendix I – Detailed Objectives, Scope, and Methodology .....	Page 20
Appendix II – Major Contributors to This Report.....	Page 23
Appendix III – Report Distribution List .....	Page 24
Appendix IV – Analysis of Income Tax Return Examination Trends from Fiscal Year 1997 to 2001 .....	Page 25

**Management Advisory Report: The Internal Revenue Service's Response  
to the Falling Level of Income Tax Examinations and Its Potential Impact  
on Voluntary Compliance**

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**Background**

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The Internal Revenue Service (IRS) views the examination of income tax returns as an important tool to encourage voluntary compliance. One measure of the IRS' overall examination program is the "examination coverage rate," commonly known as the "audit rate," which is figured by dividing the number of returns examined by the total number of tax returns filed in the previous calendar year.

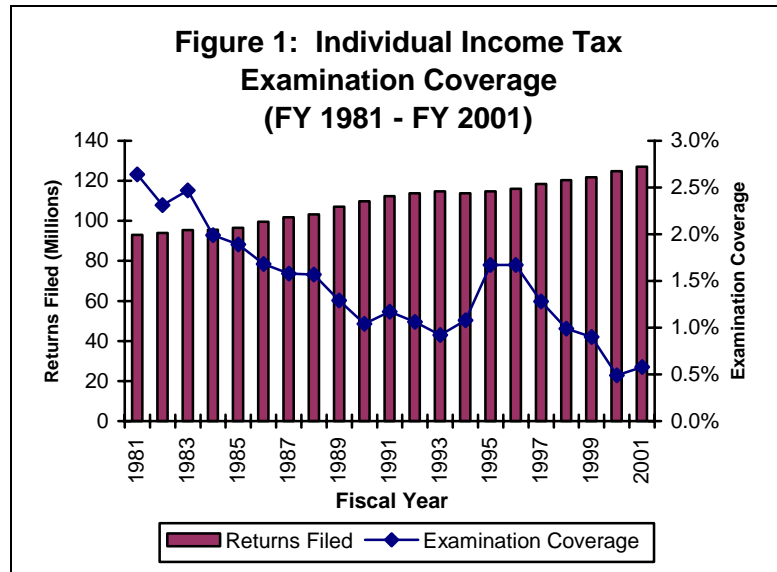
In the last 4 years, overall income tax return<sup>1</sup> examination coverage fell 56 percent, from 1.27 percent in Fiscal Year (FY) 1997 to 0.56 percent in FY 2001. Historically, this rate has fluctuated from year-to-year, but has been in a continual long-term decline. This can be illustrated in the declining coverage for individual examinations from FY 1981 to FY 2001, shown in Figure 1.

Historically, the IRS has identified insufficient staff resources and increased return filings as the reason for declining examination coverage rates. For example, the IRS Commissioner's 1990 Annual Report stated that the overall individual examination coverage rate had fallen from 0.92 percent in FY 1989 to 0.80 percent in FY 1990. This decline was attributed to an increase in returns filed and insufficient staffing increases.

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<sup>1</sup> This figure includes U.S. Individual Income Tax Return (Form 1040), U.S. Income Tax Return for Estates and Trusts (Form 1041), U.S. Partnership Return of Income (Form 1065), U.S. Corporation Income Tax Return (Form 1120), and U.S. Income Tax Return for an S Corporation (Form 1120S).

## Management Advisory Report: The Internal Revenue Service's Response to the Falling Level of Income Tax Examinations and Its Potential Impact on Voluntary Compliance



Source: Treasury Inspector General for Tax Administration (TIGTA) Analysis of IRS Trac information and Draft FY 2001 IRS Databook Information.

Recently, the Congress and other stakeholders have expressed concerns about the declining examination coverage rate and the potential effect on voluntary compliance. On March 26, 2001, the IRS Commissioner wrote to the Congress, stating:

*With the use of document matching as well as other return verification techniques that will eventually be enabled by new technology, it is my view that there is no need to return to the levels of individual audit coverage that existed even five years ago, which was three times the FY 2000 level. ...However, our strategic plan sets forth an approach in the short run to stabilize our level of traditional compliance activities, such as individual audits, at or slightly above current levels and to focus them on areas where they are most required. In the long run, we will rely on our business systems modernization program to increase the effectiveness and efficiency of these activities.*

## Management Advisory Report: The Internal Revenue Service's Response to the Falling Level of Income Tax Examinations and Its Potential Impact on Voluntary Compliance

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Again in testimony before a subcommittee of the House Appropriations Committee on February 28, 2002, the Commissioner stated, *We believe that compliance activity levels will increase over the next three years, and ...[we] will also be able to better identify and focus on key compliance problem areas.*

The IRS defines three types of voluntary compliance:

- Filing compliance – the timely filing of any required return.
- Reporting compliance – the accurate reporting of income and tax liability.
- Payment compliance – the timely payment of all tax obligations.

To verify information on income tax returns as a way to help achieve reporting compliance, the IRS uses two primary methods. The first is document matching, which verifies third party information documents to amounts reported on income tax returns. This program closed over 1.6 million returns in FY 2001. The second method is the income tax return examination, which may examine a tax return for a variety of reasons and take place in one of several ways, all of which compare entries on the taxpayers' tax return to the taxpayers' own books and records. In FY 2001, the IRS examined approximately 779,000 income tax returns.

This review is part of our FY 2002 emphasis focusing on the Large and Mid-Size Business (LMSB) and the Small Business/Self-Employed (SB/SE) Divisions' strategic initiatives. The review was conducted in accordance with the President's Council on Integrity and Efficiency's *Quality Standards for Inspections* between October and December 2001. On-site work was performed in the LMSB and SB/SE Divisions' Headquarters in Washington, DC, and at the IRS offices in Springfield, New Jersey.

Details on our objectives, scope, and methodology are presented in Appendix I. Major contributors to this report are listed in Appendix II.



## **Management Advisory Report: The Internal Revenue Service's Response to the Falling Level of Income Tax Examinations and Its Potential Impact on Voluntary Compliance**

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### **Internal Revenue Service Actions Underway to Address Concerns Over Declining Examination Rates and Results**

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Like the Congress and other stakeholders, the IRS is concerned about the declining examination rates and results. To address these current declines, the IRS is implementing both short-term and long-term actions, such as increasing resources available to examine tax returns, improving its examination work processes, and implementing strategies to improve voluntary compliance.

#### **The IRS has reduced details of Income Tax Examiners to Customer Service during the tax return filing season**

In the past several tax return filing seasons,<sup>2</sup> the IRS detailed Examination function employees to help provide better levels of customer service by answering incoming telephone calls and working at walk-in centers. In FY 2000, the IRS transferred 420 Revenue Agent and 185 Tax Auditor staff years to provide taxpayer assistance during the filing season. This reduced 605 staff years from the examination programs. However, beginning in FY 2001 the IRS reduced examination staff details to customer service by 74 percent from the FY 2000 level. This should have an immediate effect on increasing the examination rate and results achieved.

#### **The IRS has hired additional Examination staffing**

To further increase Examination staffing, the IRS hired 646 new Revenue Agents and 126 new Tax Compliance Officers (TCO)<sup>3</sup> in June and July 2001. This hiring initiative will likely be a longer-term solution, since these new employees usually spend several years training and gaining experience before developing into fully productive journeyman income tax examiners.

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<sup>2</sup> The filing season is the period between January and mid-April when most individual income tax returns are filed.

<sup>3</sup> Revenue Agents conduct field examinations of individuals, partnerships, and corporations, generally at the taxpayer's place of business. TCOs, formerly known as Tax Auditors, conduct office examinations, usually involving individuals, through interviews at an IRS office.

**Management Advisory Report: The Internal Revenue Service's Response  
to the Falling Level of Income Tax Examinations and Its Potential Impact  
on Voluntary Compliance**

---

**The IRS is in the process of improving income tax  
examination efficiency**

Actions the IRS is undertaking to improve examination efficiency and reduce examination time per return will have mid to long-term effects. Both the SB/SE and LMSB Divisions are analyzing their examination processes and procedures to identify ways to decrease the hours needed to perform examinations. So far the SB/SE Division's analysis has shown the need for more first line manager involvement. Specific recommendations included the need for Team Managers to:

- More effectively use management reports to monitor cases with high time charges, inactivity and other indicators of trouble, so that they can proactively address problems.
- Evaluate whether examinations are taking place at the taxpayers' place of business or at the taxpayers' tax professionals'<sup>4</sup> place of business, where the taxpayers' books and records supporting their income tax return are maintained.

The LMSB Division is implementing an improvement initiative to reduce Direct Examination Staff Years (DESY) charges. For the Coordinated Industry Case (CIC)<sup>5</sup> Program, the goal is a 20 percent reduction over 2 years that will reallocate DESY to the Industry Case (IC) Program. On the IC Program, the goal is a 20 percent reduction in time applied per return over 3 years.

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<sup>4</sup> "Tax professionals" are Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries, and unenrolled tax return preparers.

<sup>5</sup> Formerly known as the Coordinated Examination Program (CEP), the CIC Program examines the nation's largest, most complex taxpayers. Currently the program consists of 1,700 taxpayers (primarily corporations), of which about 1,300 are under examination at any given time.

**Management Advisory Report: The Internal Revenue Service's Response  
to the Falling Level of Income Tax Examinations and Its Potential Impact  
on Voluntary Compliance**

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**The IRS is evaluating work processes to improve the  
delivery of the Examination Program**

The IRS initiative to reengineer work processes to improve efficiency and effectiveness will have mid- to long-term effects. In FY 2001, the SB/SE Division began a 12-month project to reengineer its examination process. Changes will begin in FY 2002.<sup>6</sup> The LMSB Division launched a similar post-filing improvement process at the beginning of FY 2002.

The LMSB Division has also developed an automated workload analysis system to match human resources to location and risk. The LMSB Division intends to perform this analysis annually using the previous year's return data, completing it no later than April of each year.

The LMSB Division workload analysis was used to support decisions for promotions and the realignment of employees and teams between territories, field directorships, and industries. The analysis was also used to better match resources with workload and to support the decision to transfer the \$5 to \$10 million-asset work from the LMSB Division to the SB/SE Division to better meet the customer needs of that taxpayer segment<sup>7</sup> beginning in FY 2002.

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<sup>6</sup> In December 2001, TIGTA issued a report titled, *Management Advisory Report: The Small Business/Self-Employed Division Needs to Further Consider the Impact of Potential Examination Reengineering Recommendations* (Reference Number 2002-30-035, dated December 2001). The report concluded that many of the 23 initiatives would likely improve the control environment, but management would have difficulty measuring effectiveness of the initiatives on examination productivity. The report also concluded that some of the initiatives needed more careful consideration of their effect on taxpayer relations/taxpayer rights. The final phase of the project began in January 2002, with a planned conclusion in May 2002.

<sup>7</sup> When these two new IRS divisions were established at the end of FY 2000, SB/SE Division taxpayers were defined, in part, as having up to \$5 million in assets; LMSB Division taxpayers had assets above that level. Beginning in FY 2002, the thresholds were changed, so that now SB/SE Division taxpayers are defined as having assets up to \$10 million, and LMSB Division taxpayers as having assets above that amount.

**Management Advisory Report: The Internal Revenue Service's Response to the Falling Level of Income Tax Examinations and Its Potential Impact on Voluntary Compliance**

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**The IRS is implementing strategies to improve voluntary compliance that will permit a reduced reliance on income tax examinations**

In another longer-term initiative, the IRS plans to address voluntary compliance through taxpayer education activities, partnership outreach efforts with significant stakeholder groups, and voluntary agreements with taxpayers.

The IRS believes an important contribution towards increasing overall compliance will be the information sharing process between its examination functions, and taxpayer education and communication functions. Further, partnership outreach feedback will also be used to design, develop and deliver products and services focused on identified customer needs. Some of the outreach services now offered by the IRS are the following.

- The SB/SE Division's Voluntary Compliance Agreement Program permits a taxpayer to enter into an agreement for a specific tax issue. Tip Reporting Agreements are an example of a Voluntary Compliance Agreement.
- The LMSB Division's Industry Issue Resolution Program encourages taxpayers, industry associations and other groups to suggest issues that involve frequently disputed tax issues that impact a large number of industry taxpayers. If the suggestion is accepted, the LMSB Division will then analyze the issue, develop the facts and propose a solution. The end result of the process is to publish guidance.
- The LMSB Division's Pre-filing Agreement (PFA) Program provides for a pre-filing examination. This process can resolve some tax issues more effectively and efficiently than a post-filing examination, because the taxpayer and the IRS have more timely access to the relevant records and personnel. The TIGTA reviewed the PFA pilot in its report titled, *The Pre-filing Agreement Pilot Project Was Successful, But Faces Challenges in Converting to*

**Management Advisory Report: The Internal Revenue Service's Response  
to the Falling Level of Income Tax Examinations and Its Potential Impact  
on Voluntary Compliance**

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*an Operational Program* (Reference Number 2001-35-125, dated August 2001).

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**Declining Field and Office  
Examination Coverage Likely  
Contributing to Reducing  
Voluntary Income Tax Reporting  
Compliance**

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While we are encouraged by the IRS' efforts to reverse the declining examination coverage trend, we are concerned whether the planned actions will significantly reverse the downward course, especially in the near future. In January 2002, the IRS Oversight Board reported that its most recent survey found that between 1999 and 2001 there was an 11-point drop, from 87 percent to 76 percent, in the number of Americans that consider it unacceptable to cheat on their income taxes. This sharp decline suggests there may be an erosion in voluntary compliance.

**The Examination Program has been in decline**

In the years immediately prior to and during the time frame of this 11-point drop, the IRS' examination rate and other key measures were also in decline. In our opinion, this continuous decline in the IRS examination rate may be having an adverse affect on voluntary compliance.

Between FY 1997 and 2001, the number of income tax return examinations fell 51 percent, from 1.6 million to 779,000 returns examined, while the number of income tax returns filed grew 8 percent, from 128 million to 138 million. Thus, income tax examination coverage fell 56 percent for the same period, from 1.27 percent of all income tax returns filed to 0.56 percent, while the associated recommended examination assessments declined 29 percent, from \$24.9 billion to \$17.7 billion.

The decline in examination coverage rates and the corresponding loss in examination output can be illustrated in detail by analyzing the Non-CIC Program of Revenue Agent income tax examinations. The Non-CIC Revenue Agent income tax examinations declined 62 percent, from 306,769 returns in FY 1997 to 117,174 returns in FY 2001. For extensive information on the different IRS examination programs and a detailed analysis of examination program trends from FY 1997 to FY 2001, see Appendix IV.

**Management Advisory Report: The Internal Revenue Service's Response  
to the Falling Level of Income Tax Examinations and Its Potential Impact  
on Voluntary Compliance**

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**Many factors affect examination tax assessments**

The factors that affect the amount of additional taxes assessed are complex. Numerous factors can contribute to the amount of additional assessments, such as changes in the examination requirements caused by the IRS Restructuring and Reform Act of 1998<sup>8</sup> (RRA 98), organizational changes, and employee morale. The direct effects of these factors are difficult to objectively assess.

Two resource factors must be analyzed. The first is the number of employees available to perform examinations. Between FY 1997 and FY 2001 the number of Income Tax Revenue Agents declined 26 percent, from 10,591 to 7,848. The second element to analyze is the time applied to examine each tax return. This is a measure of efficiency. Between FY 1997 and FY 2001, the hours of Direct Examination Time (DET) applied per return increased 47 percent, from 30 hours to 44 hours.

This change in efficiency had a dramatic effect on examination coverage for Non-CIC Program returns. Though we cannot objectively quantify the numerous causes contributing to the decline in the number of income tax examinations, such as dislocations caused by the IRS restructuring and changes in employee morale, we can illustrate the erosion due to the increase in DET required to close Non-CIC examinations. If the FY 1997 time applied per return had been maintained in FY 2001, the IRS would have examined over 45,000 more returns than it did (see Figure 2). Put another way, the change in efficiency had the effect of eliminating more than 800 Full Time Equivalents (FTE)<sup>9</sup> from income tax return examinations in FY 2001, above those already lost due to the decline in staffing levels. Thus, the drop in output is attributable to more than just the decline in staffing resources. Due to this decline in output, recommended examination assessments directly attributable

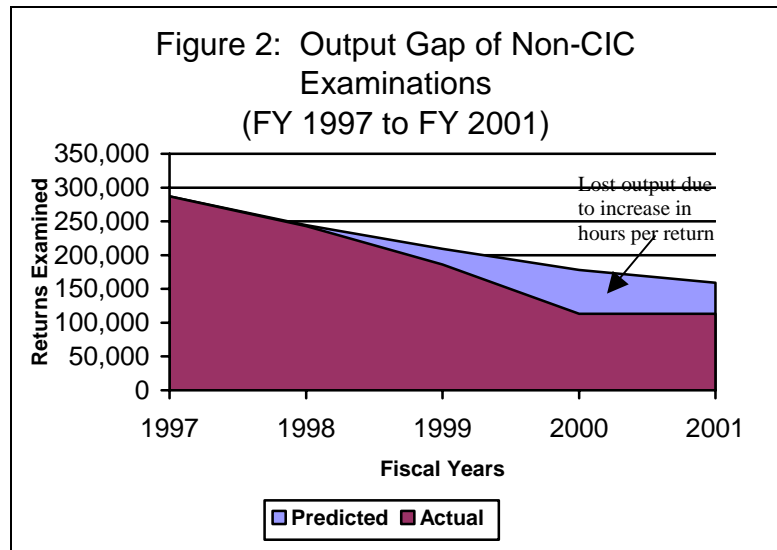
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<sup>8</sup> Pub. L. No. 105-206, 112 Stat. 685 (1998).

<sup>9</sup> An FTE generally includes 260 compensable days (2,080 hours), whereas a staff year used for planning purposes is composed of 2,000 staff hours.

## Management Advisory Report: The Internal Revenue Service's Response to the Falling Level of Income Tax Examinations and Its Potential Impact on Voluntary Compliance

to income tax return examinations declined 54 percent, from \$7.9 billion in FY 1997 to \$3.7 billion in FY 2001.



Source: TIGTA Analysis of Examination Program Monitoring, Table 37 (FY 1997 – FY 2001).

### **Examinations impact voluntary compliance**

Voluntary income tax compliance is determined by a wide variety of factors that interact differently for each taxpayer. Among the many factors are the taxpayer's perception of the fairness of the tax system, the taxpayer's own honesty, and the taxpayer's perception of being detected by an income tax examination.

One factor affecting voluntary compliance that has received academic scrutiny is the effect of income tax examinations on voluntary tax reporting compliance. Though we cannot quantify the effect in this report, two academic studies have found a significant correlation between the examination coverage rate and the level of voluntary compliance. A third study using a controlled experiment showed that the threat of an examination increases income tax reporting

## Management Advisory Report: The Internal Revenue Service's Response to the Falling Level of Income Tax Examinations and Its Potential Impact on Voluntary Compliance

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compliance of both low income and middle income taxpayer groups.<sup>10</sup>

In their study titled, "The Effect of Audit Rate on the Federal Individual Income Tax, 1977-1986," professors Jeffrey A. Dubin, Michael A. Graetz, and Louis L. Wilde<sup>11</sup> found the examination rate has a significant positive effect on the tax reported per return. The authors interpreted the positive effect of the examination rate on reported tax per return and assessed liability per return as arising from increased compliance. They concluded that there was a strong correlation between the examination rate and overall taxpayer compliance. The authors projected that the indirect effects of examinations produced six out of every seven dollars of additional revenue.

An internal IRS study titled, "The Determinants of Individual Income Tax Compliance,"<sup>12</sup> also found that examinations have a strong, positive effect on reporting compliance. Using data aggregated at the state level and compiled for a 10-year period between 1982 and 1991, the author developed an econometric model that estimates the average indirect effect of field and office examinations started in 1991. He concluded that for every \$1.00 in tax adjustments on an examination opened in 1991, \$11.60 of tax was voluntarily reported on individual income tax returns as an indirect effect.

Similar to the earlier study, the author determined that if the examination rate had been held constant at its 1982 level of 1.62 percent (instead of declining to 0.65 percent as it had), the cumulative impact through 1991 would have been that an additional \$257 billion of tax would have been

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<sup>10</sup> Each of these studies was limited to individual income taxpayers that included wage earners, self-employed and supplemental income earners. The results of the studies do not permit the breakdown of the results by the various component groups that filed individual income tax returns.

<sup>11</sup> *National Tax Journal* 43 no. 4 (December 1990): 395-409.

<sup>12</sup> IRS Publication 1916 (Rev. 11-96).



## Management Advisory Report: The Internal Revenue Service's Response to the Falling Level of Income Tax Examinations and Its Potential Impact on Voluntary Compliance

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voluntarily reported due to the indirect effect. The author contended that:

*This is strong evidence that audits are a potent tool to foster voluntary compliance. In fact, since the effect is significantly larger than the direct revenue effect of the audits, these results suggest that the allocation of audit resources (which is currently based almost solely on their direct revenue potential) ought to be modified to give more weight to this indirect effect on voluntary compliance.*

In a third study titled, “The Determinants of Income Tax Compliance: Evidence From a Controlled Experiment in Minnesota,” professors Marsha Blumenthal, Charles Christian, and Joel Slemrod<sup>13</sup> describe a controlled experiment carried out with the Minnesota Department of Revenue. In the experiment, a stratified sample was selected based on three levels of 1993 income: low-income with Adjusted Gross Income (AGI) less than \$10,000; middle-income with AGI between \$10,000 and \$100,000; and high-income with AGI over \$100,000. The sample was split into a treatment group and a control group. The Minnesota Department of Revenue informed the treatment group by mail that both their state and federal income tax returns would be “closely examined.”

The resulting increases in reported income and tax liability between the treatment group and the control group show that the heightened threat of examination increases income tax reporting compliance among low and middle-income taxpayers. However, with high-income taxpayers the threat had the opposite effect and reported income and tax liabilities actually decreased. The authors explained

*...there is reason to suspect that high-income taxpayers may react by reporting even less*

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<sup>13</sup> National Bureau of Economic Research, Working Paper No. 6575 (May 1998) JEL H26.

## Management Advisory Report: The Internal Revenue Service's Response to the Falling Level of Income Tax Examinations and Its Potential Impact on Voluntary Compliance

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*income than before, based on a perception that an audit is in reality a negotiation process for which an initial 'low bid' may be optimal.*

Therefore, based on the results of these previous studies, it is likely the decline in the examination rate has had a detrimental effect on tax reporting compliance.

### **The IRS' approach to examinations did not change with the changing environment**

Even though the IRS was aware of at least two of these studies and the indirect effect that the examination coverage rate had on voluntary compliance, the fundamental approach to increasing coverage was not altered as the staff available to conduct examinations declined. This is due at least in part to the way examination activities are measured.

The IRS policy statement on the selection of returns for examination describes both the purpose of tax return examinations and the concept of coverage:

*The primary objective in selecting returns for examination is to promote the highest degree of voluntary compliance on the part of taxpayers. This requires the exercise of professional judgment in selecting sufficient returns of all classes of returns in order to assure all taxpayers of equitable consideration, in utilizing available experience and statistics indicating the probability of substantial error, and in making the most efficient use of examination staffing and other resources.<sup>14</sup>*

Prior to the passage of the RRA 98, the IRS used a series of productivity indicators to measure the success of its examination program. These measures included:

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<sup>14</sup> Internal Revenue Manual (IRM) 1.2.3 Chapter 3 P-4-21 (2000).

**Management Advisory Report: The Internal Revenue Service's Response  
to the Falling Level of Income Tax Examinations and Its Potential Impact  
on Voluntary Compliance**

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- Recommended assessments per hour of direct examination time (dollars per hour).
- Recommended assessment per return (dollars per return).
- Total adjusted revenue (the amount of adjustments to taxable income including reductions in disallowed net operating losses used specifically in measuring the Coordinated Examination Program).
- Protection of revenue (the amount of disallowed claims for refund of previously paid taxes made by taxpayers).
- Hours of direct examination time per return (hours per return).
- Number of days the examination of the return was open (cycle time).
- The percentage of returns examined where no change was made to the tax liability during the examination (no-change rate).

The IRS' historic emphasis on achieving numeric targets did not adequately consider the impact on quality case work, fair treatment of taxpayers, and employee satisfaction.

To comply with the RRA 98 and the Government Performance and Result Act of 1993 (GPRA),<sup>15</sup> the IRS developed balanced measures as part of the effort to modernize itself and to reflect its priorities as articulated in its mission and strategic goals. To promote balance, three divergent measures are used.

- Business results – The goal of this element is to generate a productive quantity of work in a quality manner and to provide meaningful outreach to all customers.

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<sup>15</sup> Pub. L. No. 103-62, 107 Stat. 285 (1993).

**Management Advisory Report: The Internal Revenue Service's Response to the Falling Level of Income Tax Examinations and Its Potential Impact on Voluntary Compliance**

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- Customer satisfaction – The goal of this element is to provide accurate and professional services to internal and external customers in a courteous, timely manner.
- Employee satisfaction – The goal of this element is to create an enabling work environment for employees by providing quality leadership, adequate training, and effective support services.

In addition to customer and employee feedback to evaluate the success of the field and office examination program, the IRS uses business results indicators like:

- Number of cases/returns closed.
- Direct examination staff years applied.
- Quality measurement system score.
- The number of months from tax return file date to examination closure.

These measures have a peripheral connection to the old productivity indicators that are still in use as diagnostic measures for planning and control purposes. However, none of the business results indicators directly measures the effect examinations are having on voluntary tax reporting compliance, which is the primary purpose for an examination. Therefore, in our opinion perhaps the most important aspect of examination activity, the indirect effect on voluntary tax reporting compliance, is not measured.

Both the LMSB and the SB/SE Division Commissioners have recognized that a fundamental change in the IRS' examination strategy is needed. Both have initiatives to implement strategies involving "issue management." This would shift from examining an entire return to examining specific issues on the return.

The LMSB and SB/SE Divisions are at different points in implementing an issue management strategy. The LMSB Division currently has four sub-teams in various stages of implementing parts of its issue management strategy. They have worked with a contractor to design the different facets

## Management Advisory Report: The Internal Revenue Service's Response to the Falling Level of Income Tax Examinations and Its Potential Impact on Voluntary Compliance

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of the issue management strategy. The LMSB Division has also involved stakeholders in the design process.

On the other hand, the SB/SE Division is still in the reengineering process. They have identified issue management as part of a risk-driven examination strategy intended to reduce scope, depth, and taxpayer burden through a more focused examination approach that is critical to the future examination program. Their approach has also involved outside contractors and stakeholders in the design process.

We believe that properly implemented, the issue management strategy will contribute to solving the declining examination coverage problem by reducing the overall amount of time for most income tax examinations, thus permitting more income tax returns to be examined. This will increase examination coverage, in turn fostering voluntary tax reporting compliance, **provided income tax examination staffing levels stabilize**. An additional benefit for taxpayers would be that examinations would be less intrusive and time-consuming.

During closing discussions with managers in the LMSB and SB/SE Divisions concerning the issues being reported, LMSB Division managers stated that shrinking resources directly affect future examination coverage. The initial LMSB Division model was designed to have 7,200 employees; however, a recent assessment by the Chief Financial Officer's office shows a 4,840 employee base for FY 2003.

LMSB Division management described two large and increasing demands for resources. The first demand is the resource commitment to combat abusive corporate tax shelters. The second demand is the ever-increasing concern for "Revenue Protection." This is the filing of both formal and informal claims for the refund of previously paid taxes by the LMSB Division's taxpayer population, many of which are disallowed. For example, in FY 2001 the CIC Program disallowed \$6 billion in claims on 1,044 tax returns, while the IC Program disallowed \$362 million on 1,239 income tax returns. In the first half of FY 2002 the

## **Management Advisory Report: The Internal Revenue Service's Response to the Falling Level of Income Tax Examinations and Its Potential Impact on Voluntary Compliance**

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CIC Program disallowed \$1.5 billion (58 percent) of the \$2.6 billion in claims.

SB/SE Division management described several impediments they are facing. First, they will be allocating a significant amount of resources to examinations in the National Research Program over the next several years. Other impediments include inadequate information system technology and support. Due to these limitations, the SB/SE Division plans to concentrate its discretionary work in the Non-CIC and Office Examination Programs around Unidentified Income (UI) DIF,<sup>16</sup> a system they believe will identify the most noncompliant returns with unreported income.

### **Recommendations**

The IRS Commissioner, who has the overall responsibility for the IRS' examination resources, should direct:

1. The Commissioners of the LMSB and SB/SE Divisions to accelerate their implementation of an examination strategy focusing on issue management, rather than the current return-based approach, for income tax examinations in their respective examination programs. The benefits of such a strategy are:
  - It would reduce the overall amount of time for most income tax examinations, permitting more income tax returns to be examined. This will increase examination coverage, in turn fostering voluntary tax reporting compliance.
  - It could be implemented using those returns identified as most noncompliant through present and planned workload identification and selection systems, allowing the IRS to classify specific issues on the return most likely to be in error. Income tax

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<sup>16</sup> UI DIF is a mathematical technique used to score income tax returns as to examination potential based on the likelihood of unreported income.

**Management Advisory Report: The Internal Revenue Service's Response  
to the Falling Level of Income Tax Examinations and Its Potential Impact  
on Voluntary Compliance**

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examiners should then strictly adhere to the classified items selected on the tax return or, in the IC Program, those items agreed to with the group manager during preplanning, and not arbitrarily expand the scope of the examination. For example, in a case selected using the UI DIF formula, the classified issues could be restricted to the unidentified income issue unless an expense issue warranted examination. The Revenue Agent examining the income issue would use examination techniques such as indirect methods of income detection to conduct the income probe for unreported income.

- Management's approval would be required on those exception cases where significant discrepancies were discovered during the initial examination requiring the scope of the examination to be expanded to other material items on the return. This should encourage first line management to monitor inventory more closely with regards to time charges and overage returns, and to be more pro-active in potential problem cases.
2. The Commissioners of the LMSB and SB/SE Divisions to continue to obtain stakeholder input to help develop techniques to make issue-based examinations less intrusive and time consuming.
  3. The Director, Organizational Performance Division to develop a business results component for the LMSB and SB/SE Divisions' respective "Balanced Measures" that indicates the impact examinations are having on voluntary tax reporting compliance. The benefit of such an indicator is that it would assess whether the examination programs are meeting their primary objective of encouraging voluntary tax reporting compliance.
  4. The Director, Research, Analysis, and Statistics of Income, with assistance as needed from the LMSB Division's Director, Strategy, Research and Program Planning and the SB/SE Division's Director Strategy,

**Management Advisory Report: The Internal Revenue Service's Response  
to the Falling Level of Income Tax Examinations and Its Potential Impact  
on Voluntary Compliance**

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Research and Performance Management, to test the feasibility of conducting an in-depth study across all income tax return classes to determine the indirect effect that income tax examinations have on amounts voluntarily reported. The study design should include information to determine taxpayer responses to issue management examinations rather than to full return examinations. This will permit the IRS to tailor examination strategies best suited for a specific income tax return class based on both the direct and indirect effects of examinations.

Management's Response: Management's response was due on June 3, 2002. As of June 10, 2002, management had not responded to the draft report.



**Management Advisory Report: The Internal Revenue Service's Response  
to the Falling Level of Income Tax Examinations and Its Potential Impact  
on Voluntary Compliance**

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**Appendix I**

**Detailed Objectives, Scope, and Methodology**

The objectives of the review were to (1) analyze revenue agent and tax auditor examination trends from Fiscal Year (FY) 1997 to 2001, (2) evaluate what factors, if any, reduced the amount of additional taxes recommended, and (3) assess the Internal Revenue Service's (IRS) ongoing efforts to improve its examination results. On-site tests were performed in the Large and Mid-Size Business (LMSB) Division Headquarters, the Small Business/Self-Employed (SB/SE) Division Headquarters, and at the IRS offices in Springfield, New Jersey.

To achieve the assignment's objective we extensively relied on publications issued by the IRS and on internal management reports. We did not establish the reliability of this data because extensive data validation tests were outside the scope of this audit. Except as noted above, the Treasury Inspector General for Tax Administration's (TIGTA) work was conducted in accordance with the President's Council on Integrity and Efficiency's *Quality Standards for Inspections*.

The specific tests included the following:

- I. Using the closed examined return Audit Information Management System (AIMS) database, reviewed the number and type of income tax examinations conducted by the Examination Division and its successor functions in the LMSB and SB/SE Divisions for Fiscal Year (FY) 1997 through FY 2001 to determine trends. The analysis included determining average dollars per return, average dollars per hour, average hours per return, average cycle-days per return, and the average no-change rate per return based on IRS tax return classes (Activity Code).
- II. Reviewed the mission statements of the LMSB and SB/SE Divisions with respect to tax reporting compliance, the IRS' balanced measures and the diagnostic measures used to manage the tax reporting compliance program of each division.
- III. Determined the causes for the decline in the number of tax return examinations and the actions the LMSB and SB/SE Divisions are implementing to address it.
  - A. Discussed with management the factors affecting examination productivity and how the LMSB and SB/SE Divisions are addressing the decline.

**Management Advisory Report: The Internal Revenue Service's Response  
to the Falling Level of Income Tax Examinations and Its Potential Impact  
on Voluntary Compliance**

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- B. Reviewed the development process decks of the SB/SE Division's Examination Reengineering Project and the December 2001 TIGTA Management Advisory Report about the project.<sup>1</sup>
  - C. Reviewed meeting minutes and action plans addressing the decline in the number of examinations to identify specific IRS initiatives.
  - D. Reviewed the specific actions management has implemented to address the decline in examinations.
  - E. Analyzed Table 37 "Examination Program Monitoring" for FY 1997 through FY 2001 to determine:
    - 1. The decline in the number of revenue agents and tax auditors available to examine income tax returns.
    - 2. The change in the grade structure of the revenue agent and tax auditor workforce.
    - 3. The decline in staff years of revenue agents and tax auditors devoted to examination of income tax returns and the associated increase in non-return examination activities, such as details to customer service and Headquarters.
  - F. Reviewed the results of the employee satisfaction survey conducted by the LMSB and SB/SE Divisions to identify morale issues, training issues, and other potential problems affecting income tax return examination productivity.
  - G. Reviewed information from the IRS Commissioner's Complaint Processing and Analysis Group on the number of the IRS Restructuring and Reform Act of 1998<sup>2</sup> Section 1203 complaints made, investigations initiated, and resulting actions taken against employees through FY 2001.
- IV. Determined the reduction in revenue due to the decline in the number of income tax return examinations.
- A. Estimated the reduction in revenue due to the decline in the number of examinations using the AIMS closed return databases for FY 1997 through FY 2001.
  - B. Estimated the increase in examination cycle-time using the AIMS closed return databases for FY 1997 through FY 2001.

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<sup>1</sup> *Management Advisory Report: The Small Business/Self Employed Division Needs to Further Consider the Impact of Potential Examination Reengineering Recommendations* (Reference Number 2002-30-035, dated December 2001).

<sup>2</sup> Pub. L. No. 105-206, 112 Stat. 685, Section 1203 (1998).

**Management Advisory Report: The Internal Revenue Service's Response  
to the Falling Level of Income Tax Examinations and Its Potential Impact  
on Voluntary Compliance**

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- C. Reviewed “The Effect of Audit Rates on the Federal Individual Income Tax, 1977-1986” by Jeffrey A. Dubin, Michael J. Graetz, and Louis L. Wilde<sup>3</sup> and “Determinants of Individual Income Tax Compliance”<sup>4</sup> by the IRS Statistics of Income Division. Due to the complexity of the models and the inability to obtain the necessary data, we were unable to determine the decline in tax reporting compliance associated with the decline in the rate of examinations of individual income tax return examinations. Also reviewed “The Determinants of Income Tax Compliance: Evidence From a Controlled Experiment in Minnesota” by professors Marsha Blumenthal, Charles Christian, and Joel Slemrod.<sup>5</sup>

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<sup>3</sup> *National Tax Journal* 43 no. 4 (December 1990): 395-409.

<sup>4</sup> IRS Publication 1916 (Rev. 11-96).

<sup>5</sup> *National Bureau of Economic Research*, Working Paper No. 6575 (May 1998) JEL H26.

**Management Advisory Report: The Internal Revenue Service's Response  
to the Falling Level of Income Tax Examinations and Its Potential Impact  
on Voluntary Compliance**

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**Appendix II**

**Major Contributors to This Report**

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Phillip Shropshire, Director

Frank Dunleavy, Audit Manager

Earl Charles Burney, Senior Auditor

William Tran, Auditor

**Management Advisory Report: The Internal Revenue Service's Response  
to the Falling Level of Income Tax Examinations and Its Potential Impact  
on Voluntary Compliance**

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**Appendix III**

**Report Distribution List**

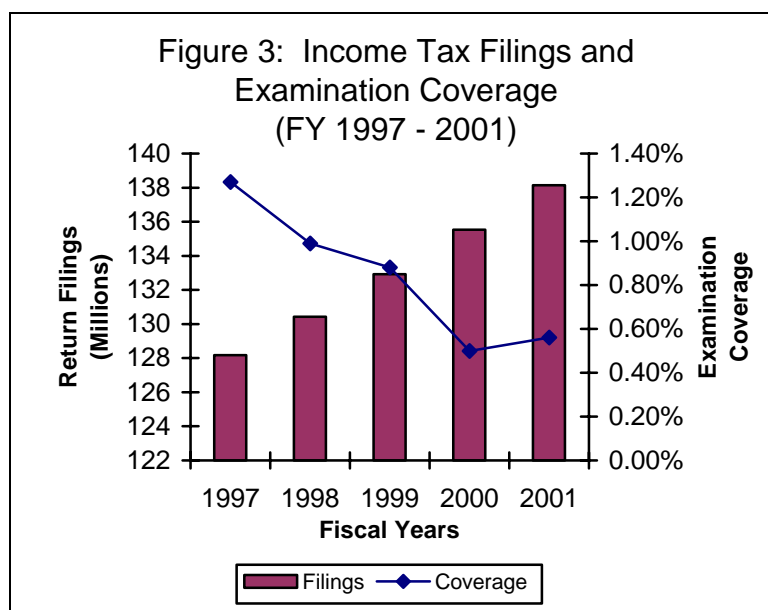
Deputy Commissioner N:DC  
Commissioner, Large and Mid-Size Business Division LM  
Commissioner, Small Business/Self-Employed Division S  
Deputy Commissioner, Large and Mid-Size Business Division LM  
Deputy Commissioner, Small Business/Self-Employed Division S  
Director, Organizational Performance Division N:CFO:O  
Director, Research, Analysis, and Statistics of Income N:ADC:R  
Director, Centralized Workload and Selection Development, Small Business/Self-Employed Division S:C  
Director, Compliance, Small Business/Self-Employed Division S:C  
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Director, Heavy Manufacturing and Transportation Industry, Large and Mid-Size Business Division LM:HCT  
Director, Natural Resources and Construction Industry, Large and Mid-Size Business Division, LM:NR  
Director, Retail, Food, and Pharmaceuticals Industry, Large and Mid-Size Business Division, LM:RFP  
Director, Strategy, Research, and Performance Management, Small Business/Self-Employed Division S:SR  
Director, Strategy, Research, and Program Planning, Large and Mid-Size Business Division LM:SR  
Chief Counsel CC  
National Taxpayer Advocate TA  
Director, Legislative Affairs CL:LA  
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O  
Office of Management Controls N:CFO:F:M  
Audit Liaisons:  
    Commissioner N:C  
    Deputy Commissioner N:DC  
    Commissioner, Large and Mid-Size Business Division LM  
    Commissioner, Small Business/Self-Employed Division S

## Management Advisory Report: The Internal Revenue Service's Response to the Falling Level of Income Tax Examinations and Its Potential Impact on Voluntary Compliance

### Appendix IV

#### Analysis of Income Tax Return Examination Trends from Fiscal Year 1997 to 2001

Overall income tax “examination coverage,” commonly known as the “audit rate” (computed as income tax examinations closed in the fiscal year divided by the tax returns filed for the previous calendar year), fell 56 percent between Fiscal Year (FY) 1997 and FY 2001, from 1.27 percent of all income tax returns filed to 0.56 percent. During this same period overall income tax return filings grew 8 percent, from 128 million to 138 million returns, while the number of income tax return examinations fell 51 percent, from 1.6 million to 779,000 returns examined (see Figure 3).



Source: Treasury Inspector General for Tax Administration (TIGTA) Analysis from FY 1997 to FY 2001 IRS Databook Information.

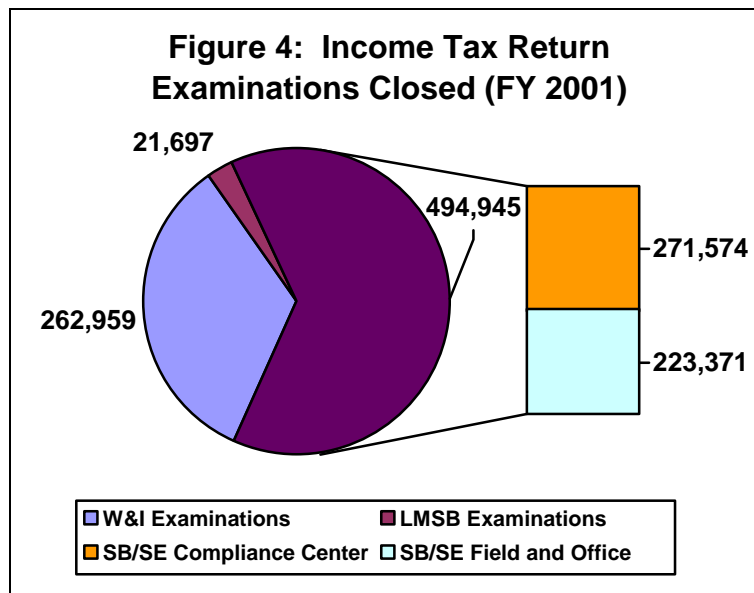
Income tax return examinations are the responsibility of three of the four Internal Revenue Service (IRS) operating divisions (see Figure 4).

- The Wage and Investment (W&I) Division has jurisdiction over approximately 122 million taxpayers accounting for 94 million returns. Almost all of the income for these taxpayers is reported to the IRS by third parties, and the vast majority of taxes are collected through third-party withholding. The W&I Division examined over 262,000 individual income tax returns in FY 2001.
- The Small Business/Self-Employed (SB/SE) Division had jurisdiction over 45 million small businesses and self-employed taxpayers with assets of \$5 million or less in FY 2001. These taxpayers consisted of 7 million small business corporation and

## Management Advisory Report: The Internal Revenue Service's Response to the Falling Level of Income Tax Examinations and Its Potential Impact on Voluntary Compliance

partnership taxpayers and 33 million self-employed and supplemental income earners. The SB/SE Division examined over 494,000 income tax returns in FY 2001. The organization is geographically based with 16 operating areas around the nation.

- The Large and Mid-Size Business (LMSB) Division had jurisdiction over approximately 224,000 business taxpayers with assets of more than \$5 million in FY 2001. The LMSB Division examined over 21,000 income tax returns in FY 2001, including 417 of the nation's largest corporations. The LMSB Division is organized into five industry units to serve taxpayers with similar needs.



Source: TIGTA Analysis from FY 2001 Draft IRS Databook Information.

We previously described in detail the increase in tax return filings and the decline in the number of tax return examinations in the report titled, *Management Advisory Report: Tax Return Filing and Examination Statistics* (Reference Number 2001-30-175, dated September 2001). In addition, the decline has been reported in the media as raising concerns in the Congress, the IRS Oversight Board has expressed concerns in its January 2002 Annual Report, and the decline in individual income tax examinations was the subject of a General Accounting Office report titled, *IRS AUDIT RATES – Rate for Individual Taxpayer Has Declined But Effect on Compliance Is Unknown* (GAO-01-484, dated April 2001).

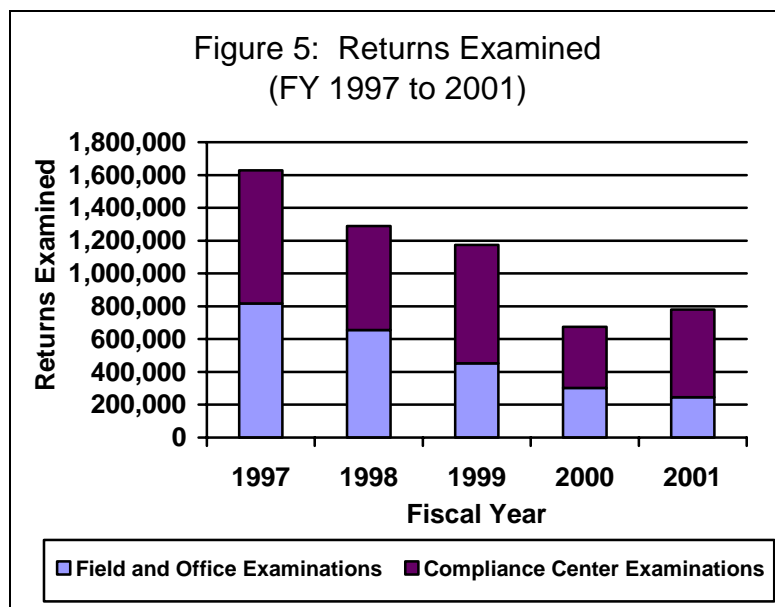
### **The IRS Has Several Different Examination Programs**

The vast majority of income tax examinations are correspondence examinations of individual income tax returns, handled out of the 10 IRS compliance centers, but these account for less than 10 percent of the recommended tax assessments. In FY 2001 the IRS conducted 534,519 correspondence examinations (69 percent of all income tax return examinations) and

## Management Advisory Report: The Internal Revenue Service's Response to the Falling Level of Income Tax Examinations and Its Potential Impact on Voluntary Compliance

recommended assessments of nearly \$1.4 billion. This represented a 34 percent decline in income tax examinations from the 1997 level when the IRS conducted 811,526 correspondence examinations (50 percent of all income tax return examinations) and recommended assessments of \$2.6 billion. Beginning in FY 2001 these compliance center correspondence examinations became the responsibility of the IRS' new W&I and SB/SE Divisions.

In contrast, the IRS' field and office examination programs account for about 92 percent of the recommended examination assessments made each year, but now account for significantly less than 50 percent of the returns examined. The field and office examination programs conduct face-to-face income tax return examinations either at the taxpayer's place of business or at an IRS office. In FY 2001 the IRS conducted 245,082 field and office examinations (31 percent of all income tax return examinations) and recommended assessments of \$16.3 billion. This represented a 70 percent decline in income tax examinations from the FY 1997 level, when the IRS conducted 816,829 field and office examinations (50 percent of all income tax return examinations) and recommended nearly \$22.4 billion in assessments (see Figure 5). Beginning in FY 2001 the field and office examination programs became the responsibility of the LMSB and the SB/SE Divisions.



Source: TIGTA Analysis from FY 1997 to FY 2001 IRS Databook Information.

The field and office examination program consists of three primary components:

- The Non-Coordinated Industry Case (Non-CIC) Program, a field examination program formerly known as the General Examination Program. It is operated by both the SB/SE and LMSB Divisions, and conducts examinations of income tax returns using a single Income Tax Revenue Agent.



## **Management Advisory Report: The Internal Revenue Service's Response to the Falling Level of Income Tax Examinations and Its Potential Impact on Voluntary Compliance**

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- The Office Examination Program operated by the SB/SE Division and conducted by employees designated as Tax Compliance Officers (TCO), formerly known as Tax Auditors.
- The CIC Program, a field examination program formerly known as the Coordinated Examination Program. It is operated by the LMSB Division and conducts examinations of the nation's largest corporations using teams of Income Tax Revenue Agents and Specialist Revenue Agents.

In the Non-CIC Program (see Figure 6), Revenue Agents' income tax examinations declined 62 percent between FY 1997 and FY 2001. In FY 1997, Revenue Agents examined 306,769 returns, or 19 percent of all income tax returns examined that year. By FY 2001, Revenue Agents examined 117,174 returns, or 15 percent of income tax returns examined that year. The decline in examinations was composed of:

- A decline in individual income tax return examinations of 63 percent, from 209,551 to 77,835 returns, with a corresponding decline in recommended assessments from \$4 billion to \$1.5 billion (63 percent).
- A decline in corporation income tax return examinations of 70 percent, from 65,217 to 19,271 returns, with a corresponding decline in recommended assessments from \$3.8 billion to \$2.0 billion (47 percent).
- An increase in fiduciary income tax return examinations of 165 percent, from 1,889 to 5,015 returns, with a corresponding increase in recommended assessments from \$49.7 million to \$119.8 million (141 percent).
- A decline in partnership income tax return examinations of 53 percent, from 7,105 to 3,307 returns.<sup>1</sup>
- A decline in S Corporation income tax return examinations of 49 percent, from 23,007 to 11,746 returns.<sup>2</sup>

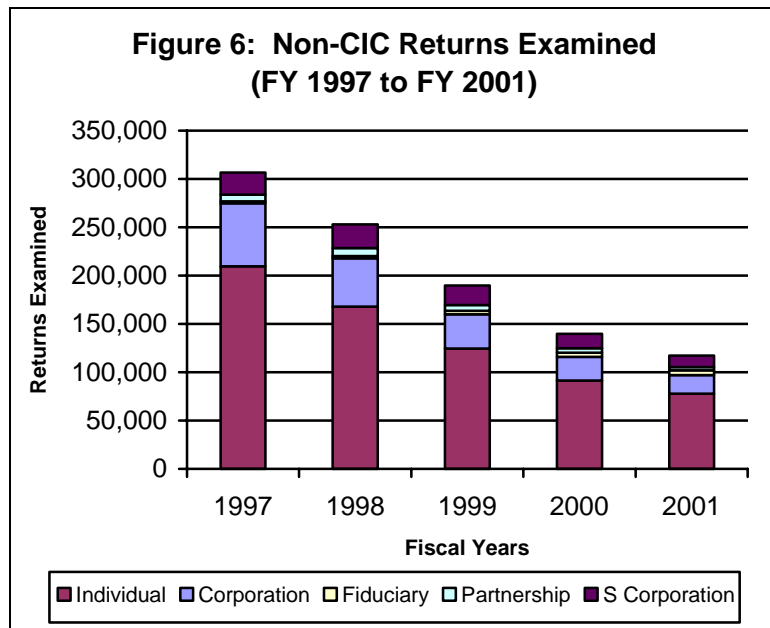
All these changes, taken together, resulted in a 53 percent decline in recommended assessments, from \$7.9 billion in FY 1997 to \$3.7 billion in FY 2001.

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<sup>1</sup> Partnership returns are not taxable. Income and expense adjustments made to them flow-through to other entities where the tax is assessed.

<sup>2</sup> S Corporation returns are not taxable. Income and expense adjustments made to them flow-through to other entities where the tax is assessed.

**Management Advisory Report: The Internal Revenue Service's Response  
to the Falling Level of Income Tax Examinations and Its Potential Impact  
on Voluntary Compliance**



*Source: TIGTA Analysis of FY 1997 to FY 2001 IRS Databook Information.*

With the end of FY 2001 the IRS completed its first full year of operation in its restructured form. Table 37, Examination Program Monitoring report shows that the SB/SE Division portion of the Non-CIC program examined 94,960 returns, or 12 percent of the income tax returns examined that year and 84 percent of the returns examined in the Non-CIC Program, resulting in recommended assessments of \$1.5 billion. The LMSB Division portion of the Non-CIC Program, now referred to as the Industry Case (IC) Program, examined 18,341 returns, or 2 percent of the income tax returns that year and 16 percent of the returns examined in the Non-CIC Program, resulting in recommended assessments of \$2.0 billion. Table 1 shows, for each type of income tax return, the number of returns filed, the number of returns examined by each division, the percentage of examination coverage contributed, and each division's percentage contribution to the Non-CIC Program in FY 2001.

**Management Advisory Report: The Internal Revenue Service's Response  
to the Falling Level of Income Tax Examinations and Its Potential Impact  
on Voluntary Compliance**

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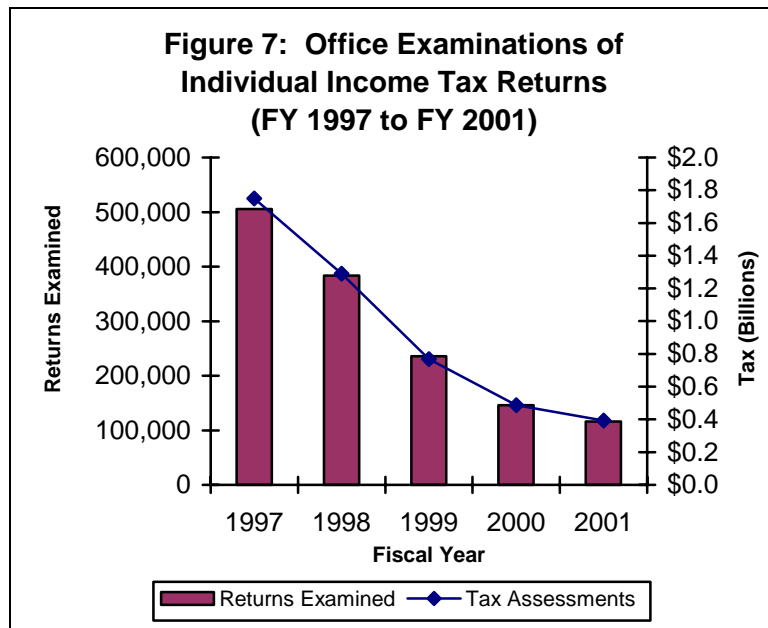
Table 1: Returns Examined in Non-CIC Program by the LMSB and SB/SE Divisions  
(FY 2001)

Return Type	Returns Filed	Returns Examined			Examination Coverage			Percentage of Non- CIC Examinations	
		Total	LMSB Division	SB/SE Division	Total	LMSB Division	SB/SE Division	LMSB Division	SB/SE Division
Individual	127,097,400	74,340	6,551	67,789	0.06%	0.01%	0.05%	9%	91%
Corporation	2,453,000	19,046	7,686	11,360	0.78%	0.31%	0.46%	40%	60%
Corporation \$5 million and less	2,343,000	11,459	1,430	10,029	0.49%	0.06%	0.43%	12%	88%
Corporation more than \$5 million	87,700	7,587	6,256	1,331	8.65%	7.13%	1.52%	82%	18%
Partnership	2,066,800	3,245	791	2,454	0.16%	0.04%	0.12%	24%	76%
Partnership \$5 million and less	1,970,427	2,454	0	2,454	0.12%	0.00%	0.12%	0%	100%
Partnership more than \$5 million	96,373	791	791	0	0.82%	0.82%	0%	100%	0%
S Corporation	2,887,100	11,655	2,790	8,865	0.40%	0.10%	0.31%	24%	76%
S Corporation \$5 million and less	2,839,599	8,865	0	8,865	0.31%	0.00%	0.31%	0%	100%
S Corporation more than \$5 million	47,501	2,790	2,790	0	5.87%	5.87%	0.00%	100%	0%
Fiduciary	3,528,900	5,015	523	4,492	0.14%	0.01%	0.13%	10%	90%
Total	138,033,200	113,301	18,341	94,960	0.08%	0.01%	0.07%	16%	84%

*Source: TIGTA Analysis of FY 2001 IRS Databook, Examination Program Monitoring, Table 37 (FY 2001), and LMSB Division Partnership and S Corporation Data.*

An even more dramatic decrease took place in the Office Examination Program. The Office Examination Program's TCO individual income tax return examinations declined 77 percent between FY 1997 and FY 2001. In FY 1997, Tax Auditors examined 505,834 returns, or 31 percent of all income tax returns examined that year. By FY 2001, TCOs examined 115,935 returns, or 15 percent of all income tax returns examined that year. This resulted in a 77 percent decline in recommended assessments, from \$1.7 billion in FY 1997 to \$394 million in FY 2001 (see Figure 7).

**Management Advisory Report: The Internal Revenue Service's Response  
to the Falling Level of Income Tax Examinations and Its Potential Impact  
on Voluntary Compliance**

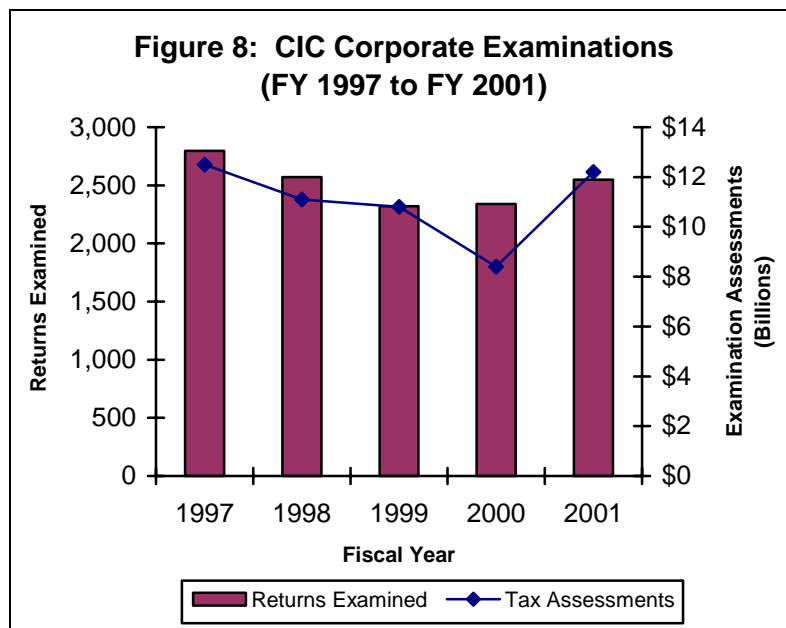


*Source: TIGTA Analysis of FY 1997 to FY 2001 IRS Databook Information.*

The CIC Program, in comparison to the Non-CIC Program and the Office Examination Program, examines far fewer returns annually but accounts for over 50 percent of the examination assessments. The number of income tax returns examined in the CIC Program declined 21 percent, while recommended assessments declined only 3 percent, between FY 1997 and FY 2001. In FY 1997, the CIC Program examined 4,226 income tax returns (0.26 percent of all income tax returns examined), recommending income tax assessments of \$12.6 billion (nearly 51 percent of all recommended examination assessments). However, by FY 2001 the percentage of all returns examined that was represented by CIC Program examinations increased, as did the percentage of assessments, while the actual number of returns fell. Specifically, by FY 2001 the number of returns examined declined to 3,343 (0.43 percent of all the income tax returns examined), with recommended examination assessments of \$12.2 billion (69 percent of all the examination assessments).

Many of these income tax returns examined were entities related to the primary corporation returns under examination and included the tax returns of individuals, corporations, partnerships, S corporations, and fiduciaries. Therefore, a better comparison of actual CIC Program activity for FY 1997 to FY 2001 period is found by looking at the number of corporation income tax return examinations that were closed. In FY 1997, the CIC Program closed 2,795 corporate income tax returns, recommending additional income tax assessments of \$12.5 billion, and in FY 2001 it closed 2,550 corporation income tax returns, recommending additional income tax assessments of \$12.2 billion. This was a nine percent decline in tax returns examined, but only a two percent decline in recommended income tax assessments (see Figure 8).

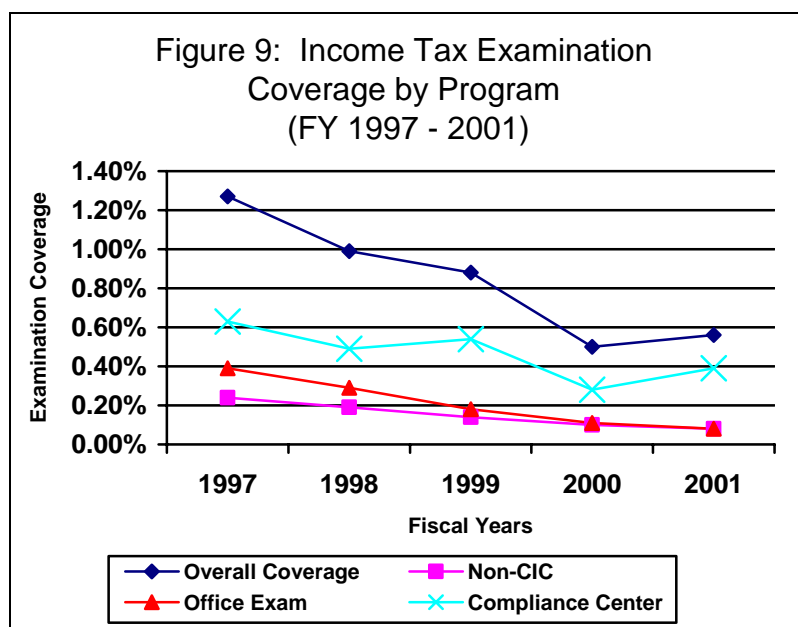
**Management Advisory Report: The Internal Revenue Service's Response to the Falling Level of Income Tax Examinations and Its Potential Impact on Voluntary Compliance**



*Source: TIGTA Analysis of FY 1997 to FY 2001 IRS Databook Information.*

Though the CIC Program accounts for the vast majority of recommended examination assessments, it examines a very small universe of approximately 1,700 business taxpayers out of a filing population 10,300 corporation tax returns with assets of over \$250 million. The program represents a fraction of the \$205 billion in corporation income tax reported voluntarily each year. By contrast, the Income Tax Revenue Agents of the Non-CIC Program are responsible for examining a portion of the remaining 2.4 million corporation returns, as well as portions of the 2.1 million partnership returns, 2.9 million S corporation returns and 3.6 million fiduciary returns filed annually. In addition, the Non-CIC Program, along with the Office Examination Program and the Compliance Center Examination Program, are responsible for examining a portion of the 127 million individual income tax returns that voluntarily report income taxes of \$978 billion annually. Figure 9 illustrates the amount of coverage contributed by the programs and the continued decline in coverage of the Non-CIC and Office Examination Programs.

## Management Advisory Report: The Internal Revenue Service's Response to the Falling Level of Income Tax Examinations and Its Potential Impact on Voluntary Compliance



Source: TIGTA Analysis from FY 1997 to FY 2001 IRS Databook Information.

As stated in the report, the concept of coverage is to examine *sufficient returns of all classes in order to assure all taxpayers of equitable consideration...and in making the most efficient use of examination staffing and other resources*<sup>3</sup> with the objective of promoting the *highest degree of voluntary compliance*.<sup>4</sup> Achievement of this objective is endangered with the declining overall coverage resulting from the shrinking number of income tax return examinations in the non-CIC and Office Examination Programs.

### **Declines in Field and Office Examination Compliance Personnel Have Reduced Staff Years Available to Examine Income Tax Returns**

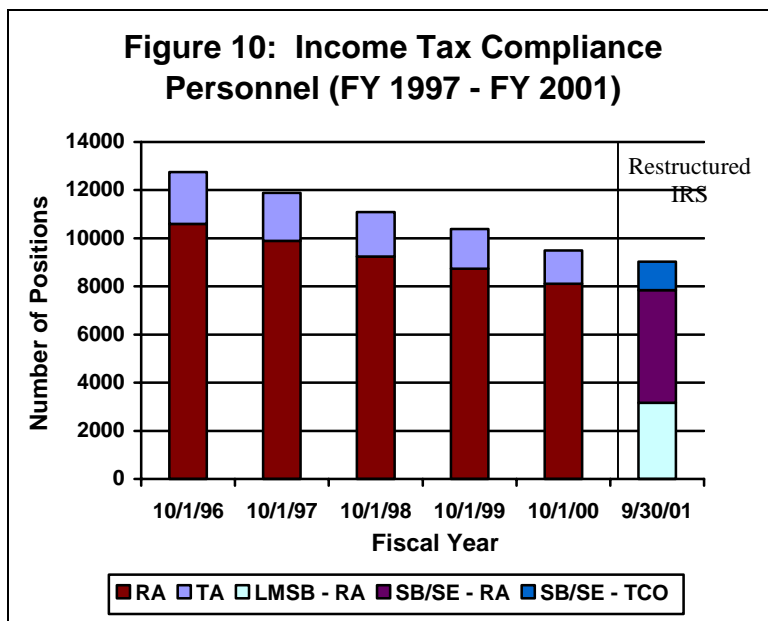
As Figure 10 shows, between FY 1997 and FY 2001 the number of Income Tax Revenue Agents and Tax Auditors, now referred to as TCOs, declined significantly, reducing the number of staff years available for conducting income tax examinations. At the start of FY 1997 the IRS had 12,755 Compliance personnel dedicated to income tax examinations, composed of 10,591 Revenue Agents and 2,164 Tax Auditors. By the end of FY 2001 the number of Income Tax Revenue Agents declined by 2,743 positions (nearly 26 percent) to 7,848 positions (3,165 in the LMSB Division and 4,683 in the SB/SE Division). The decline in staff caused an associated reduction in total staff years available for examinations, from approximately 10,023 staff years in FY 1997 to 7,620 staff years in FY 2001 (nearly a 24 percent decline).

<sup>3</sup> IRM 1.2.3 Chapter 3 P-4-21 (2000).

<sup>4</sup> IRM 1.2.3 Chapter 3 P-4-21 (2000).

## Management Advisory Report: The Internal Revenue Service's Response to the Falling Level of Income Tax Examinations and Its Potential Impact on Voluntary Compliance

The decline in Tax Auditors was even more dramatic. By the end of FY 2001 the number of Tax Auditors had fallen by 987 positions (nearly 46 percent), to 1,177 TCOs in the SB/SE Division. Again, the associated drop in staff reduced total staff years available for examinations from about 2,133 in FY 1997 to 1,306 in FY 2001 (nearly a 39 percent decline).



Source: TIGTA Analysis of Examination Program Monitoring, Table 37 (FY 1997 – FY 2001).

### **Increase in Direct Examination Time to Complete an Income Tax Return Examination Reduces the Number of Examinations that Can Be Completed**

The hours of Direct Examination Time (DET) it took to complete an examination by Income Tax Revenue Agents in the Non-CIC Program and TCOs in the Office Examination Program increased significantly between FY 1997 and FY 2001 for various reasons, including procedural changes mandated by the IRS Restructuring and Reform Act of 1998<sup>5</sup> that required agents to make third party notifications. These additional time requirements to complete examinations already in progress have reduced the amount of time available to start and complete other examinations. The increase in DET has had the same effect as eliminating nearly 1,089 Examination function staff positions on top of those actually eliminated due to declining staff levels (see Table 2).

<sup>5</sup> Pub. L. No. 105-206, 112 Stat. 685 (1998).

**Management Advisory Report: The Internal Revenue Service's Response  
to the Falling Level of Income Tax Examinations and Its Potential Impact  
on Voluntary Compliance**

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Table 2: The Loss in Examination Staffing Resources Due to the Increase in Hours of DET Per Return on Income Tax Return Examinations Conducted in FY 2001

Type of Examination	FY 2001 Hours Per Return	FY 1997 Hours Per Return	Increase in DET Hours Per Return	Returns Examined in FY 2001	Total Additional Hours of DET on FY 2001 Examinations	Equivalent Positions <sup>6</sup>
Non-CIC Individual Examinations	28	20	8	74,340	594,720	297
Non-CIC Corporate Examinations	101	58	43	19,046	818,978	409
Non-CIC Partnership Examinations	59	38	21	3,245	68,145	34
Non-CIC S Corporation Examinations	62	46	16	11,655	186,480	93
Non-CIC Fiduciary Examinations	26	17	9	5,015	45,135	23
<b>Total Non-CIC</b>				113,301	1,713,458	857
Office Examinations	8	4	4	115,922	463,688	232
<b>Grand Total</b>				229,223	2,177,146	1,089

*Source: TIGTA Analysis of Examination Program Monitoring, Table 37 (FY 1997 – FY 2001).*

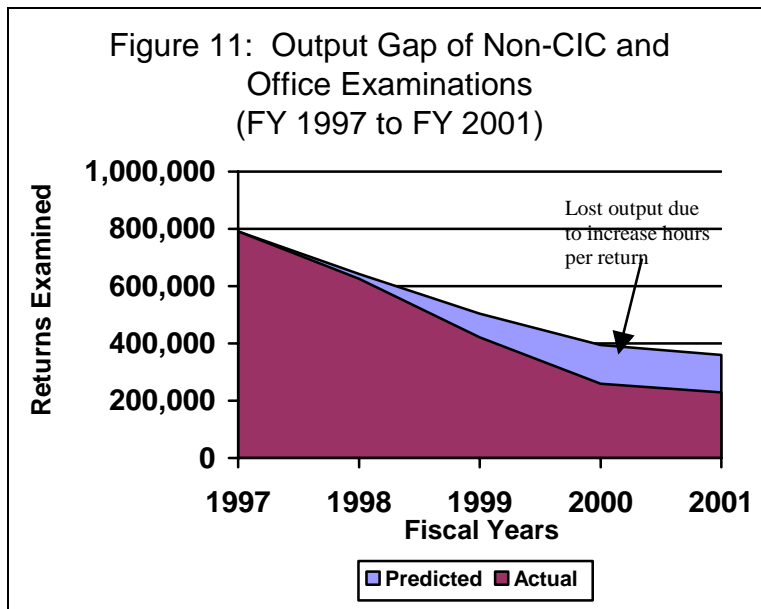
Though we cannot objectively quantify the numerous causes contributing to the decline in the number of income tax examinations, such as dislocations caused by the IRS restructuring and changes in employee morale, we can illustrate the erosion due to the increase in DET required to close Non-CIC and Office Examinations. Taking the DET for each year from FY 1998 through FY 2001, we divided it by hours of DET per return for FY 1997 to determine a predicted value of return closures for FYs 1998 to 2001. The difference between the predicted value and the actual returns examined during those years represents the lost output due to the increase in hours of DET per return (see Figure 11).

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<sup>6</sup> Based on FY 2001 Direct Examination Staff Year composed of 2000 hours of Direct Examination Time.



**Management Advisory Report: The Internal Revenue Service's Response to the Falling Level of Income Tax Examinations and Its Potential Impact on Voluntary Compliance**



Source: TIGTA Analysis of Examination Program Monitoring, Table 37 (FY 1997 – FY 2001).

It should be noted that some of the increase in time is due to legislative and procedural changes intended to protect taxpayer rights. Also, FY 1997 was a peak year in most income tax return examination categories for efficiency, as measured by hours of DET per return. Therefore, the estimate of the gap may be a “worst case” picture. However, even if these factors could be removed from the analysis, a gap would still remain (i.e., these factors alone do not explain how a 26 percent decline in the number of Income Tax Revenue Agents led to a 62 percent drop in the number of Non-CIC income tax return examinations).